Supreme Court, U.S.
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No. 98-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

LASZLO N. TAUBER, SAMUEL BURTOFF, MICHAEL A. CORRADO, DAN J. FERIOZI, IRWIN S. FREEDMAN, LESLIE P. GONDOR, REGINALD P. MCMANUS, LESLIE L. PETERS, MAGDOLNA A. IRANYI, JAMES H. SCULLY, JEFFERSON MEMORIAL HOSPITAL ASSOCIATES, JEFFERSON MEMORIAL HOSPITAL JOINT VENTURE, and JEFFERSON CORPORATION OF ALEXANDRIA,

Petitioners,

v.

COMMONWEALTH OF VIRGINIA, *ex rel.* MARK EARLEY, ATTORNEY GENERAL OF THE COMMONWEALTH OF VIRGINIA; MARK EARLEY, ATTORNEY GENERAL OF THE COMMONWEALTH OF VIRGINIA and THE COMMONWEALTH'S ATTORNEY FOR THE CITY OF ALEXANDRIA,

Respondents.

Petition for a Writ of Certiorari to the Virginia Supreme Court

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PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Virginia Supreme Court's refusal to follow the internal affairs doctrine, which required the application of the law of the state of incorporation to conduct of a board of trustees of a Maryland non-profit hospital corporation charged with a breach of fiduciary duty, violated the Commerce, Full Faith and Credit, and Due Process Clauses of the United States Constitution, and threatens to subject corporations to intolerably inconsistent legal standards of internal governance imposed by the laws of multiple states.

PARTIES TO THE PROCEEDING

This case was commenced by the Commonwealth of Virginia, *ex rel.* James S. Gilmore III, Attorney General of the Commonwealth of Virginia and the Commonwealth's Attorney for the City of Alexandria, Virginia.

Respondents in this proceeding, petitioners here and appellants before the Virginia Supreme Court, are Laszlo N. Tauber, Samuel Burtoff, Michael A. Corrado, Dan J. Feriozi, Irwin S. Freedman, Leslie P. Gondor, Reginald P. McManus, Leslie L. Peters, Magdolna A. Iranyi, James H. Scully, Jefferson Memorial Hospital Associates, Jefferson Memorial Hospital Joint Venture and Jefferson Corporation of Alexandria.

STATEMENT PURSUANT TO RULE 29.6

No petitioner has any parent or subsidiary corporations within the meaning of Rule 29.6 of the Rules of the Supreme Court of the United States.

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fully petition for a writ of certiorari to review the judgment and opinion of the Virginia Supreme Court.

OPINIONS BELOW

The opinion of the Virginia Supreme Court is reported at 255 Va. 445, 499 S.E.2d 839 (1998). 1A-12A.[1] The opinion of the Circuit Court for the County of Alexandria, Commonwealth of Virginia, is unreported, and appears at 13A-24A.

JURISDICTION

The judgment of the Virginia Supreme Court was entered on April 17, 1998. A timely petition for rehearing was filed on May 15, 1998, and denied by the Virginia Supreme Court on June 5, 1998. 25A. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(1).

STATUTES INVOLVED

This petition raises issues under the United States Constitution, specifically Article I, § 8, clause 3 (the "Commerce Clause"), Article IV, § 1 (the "Full Faith and Credit Clause") and Amendment XIV, § 1 (the "Due Process Clause"). The text of each of these provisions is set forth in the Appendix at 26A.

STATEMENT OF THE CASE

This case raises a fundamental issue of fairness, and asks whether, under the United States Constitution, a board of trustees may rely upon the protections afforded it under the laws of the state in which the corporation was formed (in this case, Maryland), or must the board risk liability for internal corporate decisions under the laws of every state in which the corporation operates, even where such laws are at odds with the law of the corporation's state of incorporation. In short, this peti-

[1] Numbers preceding the letter A denote references to the Appendix to this petition.

tion addresses whether it is constitutional, as well as fair, just and prudent, to subject a board of trustees to multiple, inconsistent state regulations. Petitioners respectfully submit that this question, and this case, present issues of both law and policy concerning the obligations of corporate trustees that are significant enough to merit this Court's consideration, and request that this Court grant their petition.

A. Background

In 1965, petitioners, a group of dedicated doctors, single-handedly and without any public financial assistance opened Jefferson Memorial Hospital, Inc. ("JMHI") in Alexandria, Virginia. Petitioners both operated the hospital and constituted its Board of Trustees. In 1971, over twenty-five years ago, the Board decided to reorganize JMHI from a non-profit to a for-profit entity. The reason for this corporate reorganization was clear; as a consequence of the lack of public funding and the commitment of the trustees to charitable care, JMHI could not raise sufficient working capital as a non-profit entity to ensure its continued viability.

Complying fully with the requirements of the corporate laws of Maryland, the state under whose laws JMHI had been formed, and expressly relying on the advice of their lawyers, petitioners took steps to effectuate the corporate reorganization under Maryland law. Pursuant to their lawyer's advice, the non-profit's considerable liabilities and meager assets were transferred to, and assumed by, a newly formed for-profit Delaware corporation, Jefferson Memorial Hospital Corporation ("JMHC"), which the Board members had created and of which they were shareholders. To further ensure the continued financial viability of the hospital, the board members also transferred to the new coporation the hospital building and equipment that they personally owned, thus putting at risk additional personal assets to provide the hospital with much-needed operating capital. Petitioners' conduct, which

was accomplished during the period 1971-1975, was expressly authorized under governing Maryland law.[2]

In 1995, twenty years after the Board's conduct had been completed in all respects, the Virginia Attorney General commenced this action, asserting that the manner in which the Board had effected the corporate reorganization constituted a breach of their fiduciary duties to the Maryland non-profit, and sought damages and an accounting on behalf of the citizens of Virginia. Notwithstanding that the Board's conduct was authorized under Maryland law, where the non-profit was incorporated, the Virginia Attorney General asserted that the reorganization violated Virginia corporate law principles. Both the Virginia Circuit Court and the Virginia Supreme Court accepted the Virginia Attorney General's suggestion that the law of the state in which the non-profit had been incorporated could be ignored, even where that law authorized the challenged conduct. In so doing, the Virginia Courts violated one of the most well established and longest-standing principles of corporate law, namely the internal affairs doctrine, and thereby deprived petitioners of their constitutional rights under the Commerce, Full Faith and Credit, and Due Process Clauses of the United States Constitution.

B. The Internal Affairs Doctrine

As stated by this Court most recently in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), "[t]he internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors and shareholders—because otherwise a corporation could be faced with conflicting de-

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[2] *Chesapeake Constr. Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970) (an insider transaction involving corporate directors is not void where the transaction is fair to the corporation); *see also* Md. Code Ann., Corps. & Ass'ns, § 2-419 (Michie 1993).

mands." 457 U.S. at 645, *citing* Restatement (Second) of Conflict of Laws, § 302, Comment b (1971).

While the internal affairs doctrine provides a clear and straightforward mechanism for resolving oftentimes difficult choice of law questions, it is more than a mere choice of law doctrine, for it is derived from, based upon, and mandated by constitutional principles, as first explained by this Court almost one hundred years ago. *See, e.g., Converse v. Hamilton*, 224 U.S. 243, 256-57 (1912) (Full Faith and Credit Clause provides a receiver with the right to sue in a state other than that in which a corporation is created and the courts of that state are required to give full faith and credit to the laws of the state of incorporation in addressing such claims); *Broderick v. Rosner*, 294 U.S. 629, 643 (1935) (application of the law of the state of incorporation to contractual liability of stockholders for tax assessments is supported by the Full Faith and Credit Clause).

In the 1980s, in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) and *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), this Court reaffirmed the importance of the internal affairs doctrine, noting that "[a] beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation." *CTS Corp.*, 481 U.S. at 90. Moreover, this Court reaffirmed the constitutional underpinnings of this doctrine as well. *Edgar*, 457 U.S. at 645 ("Illinois has no interest in regulating the internal affairs of foreign corporations;" finding unconstitutional under the Commerce Clause an Illinois statute that purported to regulate tender offers by corporations not incorporated in Illinois); *CTS Corp.*, 481 U.S. at 89 (holding Indiana tender offer statute did not offend the Commerce Clause where it did not regulate corporations not incorporated under Indiana law; "So long as each State regulates vot-

ing rights *only* in the corporations it has created, each corporation will be subject to the law of only one State. No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations." (emphasis added)).[3]

Based upon these principles, the courts across this country, until this case, have repeatedly applied this venerable doctrine to corporate choice of law issues. However, notwithstanding the sound policy justifications and constitutional principles upon which the internal affairs doctrine is based, the Virginia Supreme Court, when urged by petitioners to apply Maryland law to the claim that they had breached their fiduciary duties to a Maryland corporation, ignored this sound doctrine and inexplicably judged the conduct of a Maryland Board of Trustees under Virginia, not Maryland, law.

C. The Decisions Below

The Attorney General for the Commonwealth of Virginia commenced this action on April 26, 1995. The complaint was amended twice; culminating in a suit brought jointly by the Commonwealth of Virginia (at the relation of the Attorney General) and by the Commonwealth's Attorney for the City of Alexandria in his own name (collectively "the Commonwealth"). The Commonwealth alleged that petitioners breached their fiduciary duty to JMHI under the common law and Titles

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[3] Numerous commentators have also concluded that *Edgar* and *CTS* have reaffirmed the constitutional underpinnings of the doctrine. *See* P. John Kozyris, "Corporate Wars and Choice of Law," 1985 Duke L.J. 1, 35 (1985) ("[T]here is little question that *Edgar v. MITE Corp.* gave the single-law and lex incorporations principles an indirect but significant boost under the commerce clause"); Richard M. Buxbaum, "The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law," 75 Calif. L. Rev. 29, 54 (1987) (*CTS* "embed[ed] the state-of-incorporation version of the internal affairs doctrine in the Constitution via the dormant commerce clause").

13.1 and 55 of the Virginia Code. Petitioners contended, as they do now, that the law of the State of Maryland is controlling with respect to the issue of their fiduciary obligations to the Maryland non-profit corporation. A trial on this matter was commenced on July 15, 1996, but ended when the Commonwealth of Virginia voluntarily nonsuited the action after its witness on hospital valuation failed to qualify as an expert at trial.

The Commonwealth of Virginia filed a new complaint on July 26, 1996, and a second trial was held in January 1997. At the second trial, petitioners demonstrated that at the time of the corporate reorganization JMHI was in difficult financial straits, and the trial court, based upon this evidence, found that "the value of the corporation did not exceed its liabilities." 17A. *See also* Virginia Supreme Court decision at 9A-10A ("[T]he [trial] court concluded that defendants' expert was more persuasive than plaintiffs' and that the value of the corporation did not exceed its liabilities.") Accordingly, the trial court denied the Commonwealth's claim for money damages. 13A.

However, despite the trial court's conclusion that at the time of the reorganization the non-profit's liabilities exceeded its assets, which as a matter of Maryland law rendered the transaction fair and lawful (*see Chesapeake Constr. Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970)), the trial court, applying Virginia law, held that petitioners had breached their fiduciary duties to JMHI in approving the transaction, voided the transaction and imposed a constructive trust over JMHI's assets. 13A-24A. Faced with this clearly erroneous ruling, petitioners sought relief from the Virginia Supreme Court.

The Virginia Supreme Court granted petitioners' writ of certiorari, and petitioners argued that the lower court had erred in failing to apply Mayland law and therefore petitioners' constitutional rights were infringed. Specifically, petitioners demonstrated that the internal affairs

doctrine and the constitutional principles upon which it is based (the Commerce Clause, the Full Faith and Credit Clause, and the Due Process Clause), required that Maryland law be applied to the claims asserted by the Commonwealth of Virginia. In addition, petitioners demonstrated that the highest courts in sister states, most notably Delaware in *McDermott, Inc. v. Lewis,* 531 A.2d 206 (Del. 1987), had expressly held that the law of the state of incorporation was controlling in such circumstances, noting that the internal affairs doctrine is "one of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause—so that the law of one state governs the relationships of a corporation to its stockholders, directors and officers" and that "[t]he alternatives present almost intolerable consequences to the corporate enterprise and its managers." 531 A.2d at 216. Moreover, the Delaware Supreme Court has further concluded that *"CTS Corp. v. Dynamics Corp. of America* provides strong support for a conclusion that the commerce clause *mandates* that a state apply the internal affairs doctrine to disputes involving corporations organized under the laws of a sister state." *McDermott,* 531 A.2d at 217 n.12 (emphasis added).

The Virginia Supreme Court, in its April 17, 1998 decision (1A to 12A), acknowledged that "[Petitioners] and their supporters think this case involves the improper meddling by the Commonwealth into the internal affairs of a Maryland Corporation, contrary to settled law and violative of the Full Faith and Credit, Due Process and Commerce Clauses of the United States Constitution." 10A. However, without explanation, the Virginia Supreme Court summarily concluded "This case involves none of the above." 10A. The Virginia Supreme Court's ruling was erroneous, unconstitutional and in conflict with settled law throughout the United States. For these reasons, petitioners respectfully seek review by this Court.

REASONS FOR GRANTING THE PETITION

I. THE VIRGINIA SUPREME COURT'S REFUSAL TO APPLY THE INTERNAL AFFAIRS DOCTRINE TO THE FIDUCIARY DUTIES OF A BOARD OF TRUSTEES VIOLATES CONSTITUTIONAL PRINCIPLES AND CONFLICTS WITH THE DECISIONS OF FEDERAL AND STATE COURTS THAT HAVE PREVIOUSLY CONSIDERED THIS ISSUE

A. The Virginia Supreme Court's Decision is Unconstitutional

This Court has long recognized that the Full Faith and Credit, Due Process and Commerce Clauses impose a constitutional obligation on the part of the courts, federal and state, to apply the internal affairs doctrine to corporate choice of law issues. The failure of the Virginia Supreme Court to apply Maryland law to the internal affairs of a Maryland non-profit institution constituted an error of constitutional proportion, necessitating review by this Court.[4]

Over fifty years ago, in *Order of United Commercial Travelers of America v. Wolfe*, 331 U.S. 586 (1947), this Court unequivocally held that the Full Faith and Credit Clause required state courts to apply the internal affairs doctrine in determining corporate choice of law issues. *See also John Hancock Mut. Life Ins. Co. v. Yates*, 299 U.S. 178 (1936) (holding that a Georgia court was required to give effect to a statutory defense available under New York law but not recognized under Georgia law). In *Wolfe*, this Court expressly held that

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[4] As recognized by Justice Stevens in his concurring opinion in *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 331 (1981), while "[I]t is not this Court's function to establish and impose upon state courts a federal choice-of-law rule," this Court's authority "may be exercised in the choice of law area . . . to prevent a violation of the Full Faith and Credit or the Due Process Clause." This action presents precisely such a circumstance under those constitutional principles, as well as under the Commerce Clause.

the laws of the state under which a fraternal organization had been organized must be respected when another state's courts adjudicated matters involving the organization's internal affairs. *Id.* at 589. Indeed, this Court noted that it was "the essence of the full faith and credit clause" to require a state that had permitted a benefit society organized by another state to operate within its borders to respect the laws of the sister state pursuant to which the organization had been formed. *Id.* at 586.

While this Court narrowed somewhat the scope of *Wolfe* in its plurality decision in *Allstate Insurance Co. v. Hague*, 449 U.S. 302 (1981), holding that significant contact by a for-profit corporation with the forum state may create a state interest sufficient to satisfy a state's full faith and credit obligations, *id.* at 313, the rationale for such a conclusion does not apply to a non-profit like the institution for which petitioners served as board members. Much like a fraternal organization, the board members of a non-profit entity voluntarily associate together to pursue common interests of a charitable or other eleemosynary nature. Thus, to subject a board of trustees to conflicting regulations imposed by a multitude of different states is unduly burdensome and inequitable, as it would be for a fraternal benefit society, and offends this Court's ruling in *Wolfe*. Indeed, this very issue was presented in *NAACP v. Golding*, 679 A.2d 554 (Md. 1996), in which the Maryland court concluded that it would be inequitable to subject a non-profit organization, in that case the NAACP, to the corporate laws of multiple states, and concluded that the application of the internal affairs doctrine was both legally required and prudent with respect to non-profit institutions. *Id.* at 558-62.

The Virginia Supreme Court's decision also offends the Due Process Clause of the Fourteenth Amendment. In *Allstate Insurance Co.*, 449 U.S. at 302, Justice Stevens, in his concurring opinion, stated that "a choice-of-law decision would violate the Due Process Clause if it were totally arbitrary or if it were fundamentally unfair to

either litigant" and that "[a] choice of law decision that frustrates the justifiable expectations of the parties can be fundamentally unfair." *Id.* at 326. Justice Stevens further noted that "[t]his desire to prevent unfair surprise to a litigant has been the central concern in this Court's review of choice-of-law decisions under the Due Process Clause." *Id.*

The Virginia Supreme Court's decision sustaining a challenge to petitioners' conduct over a quarter century after it was completed, and under Virginia law, unfairly frustrated petitioners' well-settled expectations. Petitioners had taken action that was expressly authorized under Maryland law, based on the precise instructions about their corporate responsibilities provided to them by counsel. Moreover, the trial court concluded that at the time of the reorganization from non-profit to for-profit status, the non-profit's liabilities greatly exceeded its total assets. 17A. Thus, it is hard to imagine a more unfair circumstance than to charge petitioners with a breach of fiduciary duty, twenty-five years later, for conduct authorized under the law of the state which petitioners had chosen for the incorporation of the non-profit institution.

Finally, the Commerce Clause further compels the conclusion that the Virginia Supreme Court's decision was erroneous. In *CTS Corp.*, this Court acknowledged that "[a] beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation. *Id.*, 481 U.S. at 90. Moreover, this Court recognized that the Commerce Clause compelled such a result. *Id.* at 93. *See also Edgar,* 457 U.S. at 645 (holding unconstitutional on Commerce Clause grounds an Illinois tender offer statute that purported to regulate corporations "that are not incorporated in Illinois," and recognizing "Illinois has no interest in regulating the internal affairs of foreign corporations"). Thus,

because Virginia, like Illinois in *Edgar*, has "no interest in regulating the internal affairs of a [Maryland nonprofit corporation]," the burden on interstate commerce imposed by the Virginia Supreme Court by its ruling in this case is clearly excessive and unconstitutional.

The Virginia Supreme Court violated its constitutional obligations in utterly failing to explain how or why the application of Virginia law in this case (a) satisfies the Full Faith and Credit Clause, (b) provides for the "fair" result required by the Due Process Clause or (c) constitutes one of the "rare situations" where the Commerce Clause will permit the law of the state of incorporation to yield to the law of another state. Petitioners respectfully request that this Court grant their petition.

B. The Virginia Supreme Court's Decision Conflicts With the Decisions of Virtually Every Federal and State Court That Has Considered This Issue

While the scope of the internal affairs doctrine has never been defined with absolute precision, based upon longstanding constitutional principles the doctrine has, until this case, repeatedly been applied across the United States by courts faced with choice of law issues involving corporate internal affairs.[5] Moreover, on claims of breach of fiduciary duty by corporate directors and trustees and other business judgment issues of the sort involved here, both the federal courts that have considered such issues,[6]

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[5] As one commentator has noted, despite "the evolution of conflicts theory from 'choice of law' rules to the modern 'balancing of interests' methodology, the 'umbilical tie of the foreign corporation to the state of its charter' still dominates the determination of state law applicable to internal corporate affairs." Robert C. Rasmussen and Jeffrey M. Fuller, "Florida Takeover Law: Control-Share Acquisitions," 16 Fla. St. U.L. Rev. 103, 137 (1988).

[6] *Slattery v. Bower*, 924 F.2d 6, 9 (1st Cir. 1991) ("[A]ny question pertaining to the duty owed by the director of a corporation is governed by the law of the state of incorporation"); *Davis & Cox v. Summa Corp.*, 751 F.2d 1507, 1527 (9th Cir. 1985) ("Claims

involving 'internal affairs' of corporations, such as the breach of fiduciary duties, are subject to the laws of the state of incorporation"); *Treco, Inc. v. Land of Lincoln Savings & Loan*, 749 F.2d 374, 377 (7th Cir. 1984) ("The corporate law of the state of incorporation is controlling with respect to the fiduciary duties of its directors as well as other internal corporate affairs"); *Corwin v. Bresler*, 741 F.2d 410, 414 n.3 (D.C. Cir. 1984) (manipulation of business by management for personal profit; applied law of incorporation state—Delaware); *In re Reading Co.*, 711 F.2d 509 (3d Cir. 1983) (applying Delaware law to duty to minority shareholders involving claims of self-dealing); *Gregg v. U.S. Indus., Inc.*, 715 F.2d 1522, 1537 (11th Cir.) (applied Delaware law to issue of declared dividends) *reh'g granted on other grounds*, 721 F.2d 345 (1983); *Lewis v. Knutson*, 699 F.2d 230, 239 (5th Cir. 1983) (applying Delaware law even though the corporation's principal place of business was Texas); *Walton v. Morgan Stanley, Inc.*, 623 F.2d 796, 798 n.3 (2d Cir. 1980) (New York conflicts rules "dictate" the application of the law of the state of incorporation in a takeover conflict); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (applying Delaware law to corporate law issues involving a Delaware corporation), *cert. denied*, 450 U.S. 999 (1981); *Miller v. AT&T*, 507 F.2d 759, 761-63 (3d Cir. 1974) (applying New York law on fiduciary duties of directors); *Polon v. Huffines*, 446 F.2d 384, 386 n. 6 (7th Cir. 1971) (applying Ohio law to breach of duty claim); *Perlman v. Feldman*, 219 F.2d 173, 175 (2d Cir. 1955) (applying Indiana law on the sale of control of Indiana corporation); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 40 (3d Cir. 1947) (duty of controlling parent to minority stockholders governed by the law of the state of incorporation); *Peabody Holding Co. v. Costain Group PLC*, 813 F. Supp. 1402, 1415 (E.D. Mo. 1993) (English law defined scope of fiduciary duties of directors of defendant corporation organized under English law even though its principal place of business was Missouri); *Adams v. Koether*, 766 F. Supp. 237, 249 (D.N.J. 1991) (applying Delaware corporate law to claims against directors of a Delaware corporation headquartered in New Jersey); *Caballero v. Anselmo*, 720 F. Supp. 1088, 1098-99 (S.D.N.Y. 1989) (court is "obliged" to apply Delaware law to claims for breach of fiduciary duty because defendant was a director of a Delaware corporation); *Burton v. Exxon Corp.*, 583 F. Supp. 405, 414 (S.D.N.Y. 1984) (applying Delaware law to declaration of dividends issue); *Massaro v. Vernitron Corp.*, 559 F. Supp. 1068, 1080 (D. Mass. 1983) (applying Delaware law, the state of incorporation, on liability for misrepresentations, even where the principal place of business of the corporation was New York); *B.J.*

and the state courts as well,[7] have been rather consistent in applying the law of the state of incorporation to such issues.

Not surprisingly, in Delaware, the leading authority on corporate jurisprudence, the internal affairs doctrine has

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McAdams, Inc. v. Boggs, 439 F. Supp. 738, 743 (E.D. Pa. 1977) (applying Arkansas law to corporate issues); *Lachman v. Bell*, 353 F. Supp. 37, 39-40 (S.D.N.Y. 1972) (applying Delaware law to issue of fiduciary duties relating to share transactions).

[7] *Distronics, Ltd. v. Disc Mfg.*, 686 So. 2d 1154, 1160 (Ala. 1996) ("Delaware law is the law applicable to the plaintiffs' breach of fiduciary duty claims because 'the established rule of conflicts law is that the internal corporate relationship is governed by the law of the state of incorporation"); *Amberjack v. Thompson*, 1997 Tenn. App. LEXIS 679 (Tenn. App. Oct. 7, 1997) (choosing to apply the law of the state of incorporation, rather than Tennessee law, based upon the internal affairs doctrine); *Gemstar Limited v. Ernest & Young*, 917 P.2d 222, 230 (Ala. 1996) ("Because this case involves the internal affairs of Gemstar and Canstar, B.V.I. law, as the law of the place of incorporation, should govern"); *NAACP v. Golding*, 679 A.2d 554, 558 (Md. 1996) ("Maryland courts have traditionally declined to interfere in management disputes under the 'internal affairs doctrine;' " applying state of incorporation law, not Maryland law, in action); *AMERCO v. Shoen*, 907 P.2d 536, 538 n.1 (Ariz. App. 1995) ("Because AMERCO is a Nevada Corporation, and because this lawsuit concerns fiduciary relations between shareholders and management, where there is a choice of law to be made, the law of Nevada, the place of incorporation, should apply."); *Kessler v. Sinclair*, 641 N.E.2d 135 (Mass. App. Ct. 1995) (applying law of the state of incorporation to breach of fiduciary duty claims); *State ex rel. Elish v. Wilson*, 434 S.E.2d 411 (W. Va. 1993) (applying law of state of incorporation to claims of breach of fiduciary duty); *Diedrich v. Miller & Assocs.*, 334 S.E.2d 308, 310 (Ga. 1985) ("We hold that the wrongful appropriation of a business opportunity of a foreign corporation by its officer or director is an internal affair not to be regulated by Georgia law. Instead, the local law of the state of incorporation applies, which is Wisconsin in this case"); *Bayberry Associates v. Jones*, 1988 Tenn. App. LEXIS 718 (Tenn. App. Nov. 9, 1988), *vacated on other grounds*, 783 S.W.2d 553 (Tenn. 1990) ("the local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation").

received the greatest attention, and the courts of that state have resoundingly declared that, contrary to the ruling by the Virginia Supreme Court here, the law of the state of incorporation must be applied to internal affairs issues. In *McDermott, Inc. v. Lewis*, 531 A.2d 206 (Del. 1987), the Delaware Supreme Court fully explained the justification and rationale for such a rule, holding:

> [T]he internal affairs doctrine is not merely a principle of conflicts law. It is also one of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause—so that the law of one state governs the relationships of a corporation to its stockholders, directors and officers in matters of internal corporate governance. The alternatives present almost intolerable consequences to the corporate enterprise and its managers. With the existence of multistate and multinational organizations, directors and officers have a significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions.

531 A.2d at 216.

Subsequent cases in Delaware have reaffirmed this principle time and again, even where, as here, the corporation's principal place of business was outside of its state of incorporation. Thus, in *Rosenmiller v. Bordes*, 607 A.2d 465 (Del. Ch. 1991), for example, the court, citing *McDermott*, expressly held that the fact that a Delaware corporation's principal place of business was in New Jersey and that it conducted much of its business there did not compel a finding that a "rare situation" existed such that the internal affairs doctrine would not be applied. 607 A.2d at 469 ("The Delaware Supreme Court, when faced with the argument that local interests outweigh the incorporating state's interest in regulating the internal affairs of a domestic corporation, rejected the concept and expressly declined to erode the principle of the internal

affairs doctrine.") *See also Wier v. Howard Hughes Med. Inst.*, 404 A.2d 140, 145 (Del. Ch. 1979) (holding that "the appropriate person to enforce the provisions of a Delaware charitable trust is the [Delaware] State Attorney General," and declining to allow the Florida Attorney General to join a suit against a Delaware charity that conducted all of its business in Florida).[8]

The Virginia Supreme Court's refusal to apply the internal affairs doctrine in this case, indeed its failure to provide even an explanation as to its rationale for rejecting the application of Maryland law, unquestionably conflicts with the sound and settled decisions of federal and state courts all across the country. Moreover, further explication by this Court concerning what constitutes those "rare situations," as described by this Court in *CTS Corp.*, in which the internal affairs doctrine may set aside is clearly both desirable and necessary. Accordingly, petitioners request that this Court grant their petition.

II. THE VIRGINIA SUPREME COURT'S DECISION CREATES INTOLERABLE CONSEQUENCES IN THE MANAGEMENT OF NON-PROFIT INSTITUTIONS OPERATING IN MULTIPLE STATES

As this Court has repeatedly recognized, application of the internal affairs doctrine "achieves the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in

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[8] A case possibly demonstrating the "rare situation" alluded to by this Court in *CTS Corp.* in which the law of the state of incorporation may yield to that of another state is *Yates v. Bridge Trading Co.*, 844 S.W.2d 56 (Mo. App. 1992). In *Yates*, a stock purchase agreement contained a choice of law provision expressly selecting Missouri law. The court, after acknowledging that the corporation at issue was a Delaware corporation and that "this would normally mean that the corporate law of Delaware would control stock issuance," *citing* Restatement (Second) Conflict of Laws § 302 (1971), considered whether the express choice of law clause should override the doctrine. After careful consideration, the court rejected Missouri law in favor of the law of the state of incorporation.

the corporation." *First Nat'l. City Bank v. Banco Para El Comercio*, 462 U.S. 611, 622 (1983). *See also Shaffer v. Heitner*, 433 U.S. 186, 215 n.44 (1977) ("[T]he rationale for the general rule [that the law of the state of incorporation is held to govern the liabilities of officers or directors to the corporation] appears to be based more on the need for a uniform and certain standard to govern the internal affairs of a corporation than on the perceived interest of the State of incorporation."). Indeed, as one noted commentator has explained:

> Internal corporate rules establish an entire system of private governance on a continuing basis involving persons—directors, officers, shareholders of various classes—performing different tasks and having potentially antagonistic interests. It would be intolerable to allow its component parts to be regulated under differing principles for different persons at different times. Rather, such a regime must be uniform and stable to promote efficient and equitable operation. The corporate participants need to know the rules of the game in advance and must be able to plan their transactions under fixed standards and procedures that determine their rights and liabilities. Beyond the requirements of unitary and constant governance, the corporate participants . . . justifiably expect and demand that they be treated equally with other persons similarly situated and not be subjected to differential treatment depending on such variables as the place where the suit was brought, where some parties reside, or where the corporation has assets or does business.

Kozyris, 1985 Duke L.J. at 49. However, the Virginia Supreme Court ignored these sound principles and its decision in this matter unquestionably has the ability to create havoc in the management of corporate affairs.

Within weeks of the Virginia Supreme Court's decision in this case, critical commentaries were published: "If the ruling is upheld, it potentially subjects governing bodies of nonprofit institutions—including colleges and universi-

ties—to liability under the laws of the state in which the institutions are incorporated *and* in every state in which the institution has a presence." Steinbach and Pelesch, "Unfriendly Territory," TRUSTEESHIP, May/June 1998 at 27.[9] Moreover, the Virginia Supreme Court's ruling "undermine[s] the stability of corporate governance" and "thwart[s] legislation [the Volunteer Protection Act of 1997] aimed at limiting the liability of directors and trustees of nonprofit corporations." *Id.* at 28.[10]

Of equal importance, the Virginia Supreme Court's decision, if allowed to stand, poses the potential to create intolerable uncertainties in the law of corporate takeovers and related internal corporate disputes. Uniformity in the application of choice of law principles is essential in such matters, for the parties to such disputes rely heavily on the rights afforded them under applicable law in launching or defending against such challenges. Accordingly, it is not surprising that commentators have noted that "not a single takeover case has been identified where, in the absence of a relevant statute, the application of a corporate law other than that of the state of incorporation was ever seriously considered." Kozyris, 1985 Duke L.J. at 19.[11] The Virginia Supreme Court's decision in this

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[9] One of the authors, Sheldon E. Steinbach, is vice president and general counsel of the American Council on Education. The American Council on Education, as well as the National Association of State Universities and Land Grant Colleges, filed an amicus brief with the Virginia Supreme Court regarding the implications of the lower court's refusal to apply the internal affairs doctrine to this case.

[10] The Volunteer Protection Act of 1997, 42 U.S.C. § 14501 (1998), was passed in response to concerns that citizens were unwilling to volunteer for various nonprofit organizations because of potential liabilities. The Virginia Supreme Court decision in this case, if permitted to stand, clearly frustrates the intent of such legislation.

[11] Professor Kozyris has further noted that "in another controversial and nuanced area of internal affairs, the termination of

case alters this well-settled and necessary principle. For this additional reason, petitioners submit that this Court should grant their petition.

CONCLUSION

For all of the foregoing reasons, petitioners respectfully request that their Petition be granted, and that they be permitted to present these issues to this Court for further consideration.

Respectfully submitted,

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derivative suits by directors, the applicable rules have again been chosen, without exception, from the law of the state of incorporation." 1985 Duke L.J. at 19.

APPENDICES

APPENDICES

APPENDIX A

IN THE
SUPREME COURT OF VIRGINIA
CITY OF RICHMOND

Record No. 971155

LASZLO N. TAUBER, *et al.*

v.

COMMONWEALTH OF VIRGINIA, ETC., *et al.*

Present: All the Justices

OPINION BY JUSTICE A. CHRISTIAN COMPTON
April 17, 1998

In this chancery suit, the Attorney General of Virginia and a commonwealth's attorney jointly assert jurisdiction in the name of the Commonwealth over assets located in Virginia held by trustees in dissolution of a foreign charitable corporation. The trustees had been directors of the corporation, which operated a hospital in this State.

A brief summary of the relevant business activities of the hospital directors will set the stage for this discussion. Jefferson Memorial Hospital, Inc. (JMHI), was chartered originally as a for-profit, stock corporation in Maryland in 1963. In 1964, the corporation amended its charter to become a nonprofit, nonstock charitable entity; it be-

gan operations as an acute-care hospital in Alexandria on March 15, 1965.

In April 1969, the federal Internal Revenue Service began an investigation leading to revocation of JMHI's tax-exempt status, retroactive to November 1, 1965. In 1971, the corporation's directors attempted to "merge" JMHI into a for-profit Delaware corporation, Jefferson Memorial Hospital Corporation (JMHC). There was an effort to dissolve JMHI and to transfer its assets and liabilities to JMHC, of which JMHI's directors would serve as directors.

In April 1973, Maryland ordered JMHI's corporate charter forfeited "for failure to file the necessary corporate personal property report or failure to pay any late filing penalties due."

In 1974, the directors retained counsel "to represent the Hospital in looking after and insuring that the Hospital Corporate structure for the past, present, and for the immediate future, be handled so as to insure that everything is legally correct and in keeping with the best interest of the investors of the Hospital," according to JMHC's minutes. Counsel testified that he was "asked to rectify the problem that had arisen because a supposed merger in '71 had not been done."

Unaware that Maryland had revoked JMHI's charter, counsel had the directors declare JMHI insolvent and approve transfer of JMHI's assets to JMHC. In January 1975, JMHC's directors authorized purchase of the assets and assumption of the liabilities. The directors of JMHC, believing they had assembled all the assets of the former charity into the for-profit corporation, agreed to transfer all JMHC's "assets" to appellant Laszlo N. Tauber as trustee for appellant Jefferson Memorial Hospital Joint Venture (JMHJV), a partnership in which those assets apparently still reside. The directors also agreed to lease back from the partnership the transferred assets.

In July 1996, the present suit was instituted by the Commonwealth of Virginia, *ex rel.* the Attorney General of Virginia and the Commonwealth's Attorney for the City of Alexandria. The defendants are Tauber and nine other named physicians, "each individually and as a former director of [JMHI] . . . and/or as partners, in Jefferson Memorial Hospital Associates, or [JMHJV], and/or directors or shareholders of [JMHC] (a Delaware Corporation now known as 'Jefferson Corporation of Alexandria')"; Jefferson Memorial Hospital Associates; JMHJV; and Jefferson Corporation of Alexandria. A prior suit had been commenced by the Attorney General against the same defendants in April 1995, but was nonsuited during trial.

In the present suit, the plaintiffs filed a 112-paragraph, 40-page, three-count bill of complaint. They alleged that funds and assets received by the defendants as directors and trustees of a charitable corporation "were misappropriated and diverted" contrary to law that requires such funds to be used only for charitable purposes, "and not for private inurement." The plaintiffs then recited in detail the defendants' alleged business activities in connection with the hospital.

In count one, the plaintiffs alleged the "purported merger between JMHI and JMHC in 1971 never took place," and the "subsequent purported transfers of the property of JMHI were likewise null and void." Asserting "JMHI was and is a non-stock foreign corporation whose assets are located in the Commonwealth" and are subject to the trial court's jurisdiction, the plaintiffs asked the court: to declare "that the purposes for which JMHI was created have been frustrated and are no longer capable of being accomplished by virtue of" the defendants' conduct; to declare that legal title to JMHI's assets remain in JMHI; to order that an appropriate custodian gather the assets of the former JMHI and administer them under the court's supervision; to require that de-

fendants account for the money or other value received in the transactions and that defendants be surcharged for the charitable assets they usurped in the amount of at least $40 million; and to enter judgment against defendants as a result of "their conversion, misappropriation, or appropriation of the charitable assets" described.

In count two, the plaintiffs sought similar relief and also asked the court "to impose a constructive trust upon the Hospital, its land, equipment and any other assets," as well as upon settlement proceeds being paid by an entity which, in 1985, negotiated with JMHJV to buy the right to operate the hospital and its assets as a going concern.

In count three, the plaintiffs asked the court to declare that "the corporate opportunities of JMHI have been usurped" by the defendants; that the defendants be required "to account for and disgorge all sums usurped;" that the court impress upon any future sums defendants may receive "an appropriate judgment or trust to secure the interests of the beneficiaries of JMHI, and, if necessary, to refer the matter to the Commissioner in Chancery for an appropriate accounting and charging order against JMHJV."

After the chancellor overruled their demurrer and plea in bar, defendants answered the bill of complaint. They generally denied the allegations, asserting the plaintiffs are not entitled to the relief prayed for, or to any other relief.

The cause was heard ore tenus in January 1997. The parties had stipulated that the trial in the present suit was to commence where the prior trial terminated, and that the record of all proceedings in the prior suit is to be a part of the present record.

Following the trial, the chancellor filed a memorandum opinion ruling that the plaintiffs are entitled to relief sought in the bill of complaint. In a March 1997 decree,

from which we awarded defendants this appeal, the court declared that the assets and liabilities of JMHI "be, reside and remain with [defendants] as trustees and further that a constructive trust be . . . imposed on such assets and liabilities."

The court also ordered that a custodian "be appointed with exclusive jurisdiction to hold and administer the said assets and liabilities." Additionally, the court ordered defendants to submit "a full and complete accounting of all assets and liabilities that are the subject of this Decree." Finally, the court denied the plaintiffs' "claim for monetary damages."

On appeal, defendants contend the trial court erred "when it concluded that the Attorney General has authority to bring this suit." The chancellor ruled "that the Attorney General has standing and authority to bring this action both at common law and pursuant to" Code § 13.1-909(B). The trial court is correct.

We need address only the common law. This Court long ago recognized the common law authority of the Attorney General to act on behalf of the public in matters involving charitable assets. *Clark* v. *Oliver*, 91 Va. 421, 427-28, 22 S.E. 175, 177 (1895). Indeed, this authority has received legislative recognition as recently as last year. During its 1997 session, the General Assembly granted the Attorney General additional specific powers with respect to the disposition of assets by nonprofit health care entities. Acts 1997, ch. 615. These powers were granted "in order that the Attorney General may exercise his common law and statutory authority over the activities of these organizations." Code § 55-532.

Next, defendants argue the chancellor erred in ruling that Code § 55-29 provides authority for the Commonwealth's Attorney of the City of Alexandria to be a proper party to the claims asserted. We disagree.

Code § 55-29 (1995 Repl. Vol.) provides, as pertinent:

> "When any such gift, grant or will is recorded and no trustee has been appointed, or the trustee dies or refuses to act, the circuit court . . . of the city in which the trust subject or any part thereof is, in the case of a gift or grant, or in which the will is recorded, may, on motion of the attorney for the Commonwealth in such court (whose duty it shall be to make such motion), appoint one or more trustees to carry the same into execution. . . . In enforcing the execution of any such trust a suit may be maintained against the trustees in the name of the Commonwealth when there is no other party capable of prosecuting such suit. The term '*trustees*' as herein used shall be construed to mean the persons, or governing body, charged with the execution of the trust, whether designated as 'trustees,' or 'directors' or otherwise. . . ."

The phrase "any such gift, grant or will" refers to Code § 55-26.1, which provides, "Every gift . . . made hereafter for charitable purposes, whether made in any case to a body corporate or unincorporated . . . shall be as valid as if made to or for the benefit of a certain natural person. . . ."

The foregoing provisions are not limited to express trusts arising by virtue of written instruments, as defendants argue, but apply, as here, when the assets of JMHI passed automatically to its directors as formal trustees of the charitable organization in liquidation. Thus, the Commonwealth's Attorney is a proper party to this litigation.

Parenthetically, because the defendants seem to raise this issue on brief, we note that use of the word "recorded" in the first clause of the first sentence of § 55-29 refers to recorded wills, and not to any requirement that gifts or grants also be recorded. This is made clear later in

the same sentence where there is specific reference to "in which the will is recorded."

Next, we shall turn to the merits. A detailed recitation of the evidence gleaned from this record would serve no useful purpose. On appeal, the defendants primarily seek to have us annul factual findings of the chancellor. The evidence, except for opinions of experts, was not in dispute; defendants urge us to invalidate the legitimate inferences drawn by the trial court from those proven facts. This tactic will not succeed upon appellate review.

The findings of a chancellor, hearing evidence ore tenus, carry the weight of a jury verdict. *Giannotti* v. *Hamway*, 239 Va. 14, 23, 387 S.E.2d 725, 730 (1990). A judgment based upon such findings will not be annulled on appeal "unless it appears from the evidence that such judgment is plainly wrong or without evidence to support it." Code § 8.01-680. And, the plaintiffs' burden is to prove these allegations by a preponderance of the evidence. *Baylor* v. *Beverly Book Co.*, 216 Va. 22, 24, 216 S.E.2d 18, 19 (1975).

Upon review we shall recite the facts, including the legitimate inferences flowing from those facts, in the light most favorable to the plaintiffs, who prevailed below. In the early 1960s, following acquisition of real estate by deed and lease by King Street Joint Venture, held by defendant Tauber as trustee, JHMI was formed to transact the business of operating a hospital. This Maryland corporation was authorized to do business in Virginia in 1963. Following the March 1965 opening, the hospital experienced "problem[s] all the time," although an expansion allowing addition of 24 beds occurred in 1968.

In 1970, during the Internal Revenue Service investigation, an attorney was retained to review "the current corporate status of the hospital." Counsel recommended "a complete reorganization of the hospital and its affiliates," establishment of "a new profit corporation with the

same name," and "that the old non-profit corporation be merged into it."

The Delaware for-profit corporation, JMHC, was formed in 1971 and a supposed merger was arranged. This merger was reported on tax returns filed in 1972, but the record is devoid of documents to support such a transaction. However, Dr. Tauber, who mainly orchestrated the myriad transactions involved in this case, testified, "In my own mind, [the merger] was completed." The chancellor said no evidence had been presented to show due diligence was used at that time to protect the interests of the beneficiaries of the charitable hospital.

The basis of the 1972 Internal Revenue Service ruling revoking JMHI's tax-exempt status was: "The hospital sold 8% bonds to various doctors and individuals in exchange for their 6% demand notes and did not enforce collection of such demand notes. Other hospital bonds were sold to the general public at 8% for cash. Some of the doctors receiving the 9% bonds in exchange for their 6% demand notes were officers, directors, and staff members of the hospital. Issuance of 8% bonds to these doctors and failure to enforce collection of the demand notes received in exchange resulted in *inurement of income to private individuals*." This was a violation of the applicable provision of the Internal Revenue Code allowing exemption of charities from federal income taxation.

In 1974, after another attorney had been retained "to rectify the problem that had arisen" because of the putative merger, documents indicate that JMHC assumed the charity's liabilities in return for receipt of JMHI's assets. The charity was to receive 5,000 shares of JMHC stock, but no such transfer was made.

The record amply supports the following findings of the chancellor. "There are numerous transactions shown, some of-record and some not, dealing with the real estate, the equipment, the leases, and the use of tax benefits. The transactions show an entire course of self-dealing by

the directors of the charity. They were able to acquire interests in the real estate, the equipment and lease, and were able to use tax benefits belonging to the former charity to enhance the gain of the for-profit corporation. The record is replete with discussions among [defendants] as to their personal profits and gains with no reference to the best interests of the beneficiaries nor of the charitable corporation. The result was the total obliteration of the non-profit corporation."

A transaction illustrative of the foregoing conclusions involves a subdivision of the hospital's real estate in 1970. The charity's 65% undivided interest was lost and, in its place, the charity obtained a 20% interest consisting of an allocated parcel. Also, after the nonprofit corporation was dissolved by Maryland authorities in 1973, defendants caused the filing of an annual report with the State Corporation Commission of Virginia that JMHI remained in good standing.

As the chancellor found, deals were "convoluted and complex with off-record real estate transactions conflicting with the state of the title as shown on-record. Net operating losses were used as tax deductions by JMHC that had become deductions [as] a result of the revocation of JMHI's tax exempt status. When [defendants] had exhausted these deductions, they began seeking ways to benefit their own tax status through a complicated series of notes and bonds, and while some personal risk was taken, the [defendants] and others were participating in the venture in basically a risk-free manner."

Defendants claimed in the trial court that JMHI had no value in 1971 and, thus, the transactions by which they assumed control of its corporate assets by the assumption of its liabilities were "fair." Responding, the chancellor determined that JMHI "had value as a 'going concern' " when the effort was made to change to a for-profit corporation. But the court concluded that defendants' expert testimony was more persuasive than plain-

tiffs' and that "the value of the corporation did not exceed its liabilities." "However," the chancellor ruled, "this does not constitute a defense to the claims made here."

The defendants' contentions regarding the merits of the suit, including the arguments advanced by amici curiae supporting defendants, are premised upon several erroneous conclusions. For example, defendants believe the trial court recognized that a legally valid "transaction" of some sort occurred in 1971.

Defendants' description of the nature of this binding "transaction" has evolved from "merger," to "reorganization," and finally, during oral argument of the appeal, to "acquisition." Also, defendants and their supporters think this case involves the improper meddling by the Commonwealth into the internal affairs of a Maryland corporation, contrary to settled law and violative of the Full Faith and Credit, Due Process, and Commerce Clauses of the United States Constitution. This case involves none of the above.

The trial court determined that no transaction in the nature of a merger or reorganization took place in 1971. The chancellor ruled that "no merger of JMHI and JMHC has occurred and that the transactions by directors of JMHI are void, the assets remained in JMHI until its dissolution. At the time of dissolution, these assets passed into and remain in the hands of [defendants] as trustees." This ruling is fully supported by the applicable law and the uncontradicted evidence, most of which was created by defendants.

Because the 1971 "transaction" never occurred, the 1973 revocation of JMHI's corporate charter converted its directors by operation of law to trustees in dissolution under Maryland law. Md. Code Ann., Corporations Art. 23, § 78(a) (1957); *Cloverfields Improvement Ass'n* v. *Seabreeze Properties, Inc.*, 373 A.2d 935, 939-40 (Md. 1977). Virginia law was and is the same. *See* former

Code § 13.1-254 (1973 Repl. Vol.); present Code § 13.1-915 (1993 Repl. Vol.).

The charter revocation terminated JMHI's corporate existence and powers, and it could no longer function as a corporation. *Cloverfields Improvement Ass'n* v. *Seabreeze Properties, Inc.*, 362 A.2d 675, 679 (Md. App. 1976). From that day forward, the defendants' actions purportedly taken as corporate officers, and not done to wind up or liquidate the business, were without effect because there was no corporation for which to act. The corporate assets had automatically transferred to the directors as trustees. *Cloverfields*, 362 A.2d at 679.

Under Maryland law, property of a charitable corporation is held in trust for the public. *Inasmuch Gospel Mission, Inc.* v. *Mercantile Trust Co. of Baltimore*, 40 A.2d 506, 510 (Md. 1945). Virginia law is the same. "The corporation was organized for charitable or benevolent or literary purposes. Contributions made to it and the assets realized therefrom were dedicated to those purposes and stamped with a public interest by the charter, the laws of this State, sound reason and public policy. The members acquired no property rights in, nor were they equitably entitled to such assets, either during the lifetime of the corporation or upon dissolution. To hold otherwise would convert the public nature and purpose of the corporation into a vehicle for the personal pecuniary gain of the members." *Hanshaw* v. *Day*, 202 Va. 818, 824, 120 S.E.2d 460, 464 (1961). Thus, the defendants' contentions that this litigation, dealing with appropriation of charitable assets by directors for their personal gain, involves impermissible interference by Virginia with the internal affairs of a foreign corporation, or that a "fairness" doctrine should be applied to the 1971 activities, are without merit.

Accordingly, the circuit court properly exercised its authority to insure that these assets, now held by the defendants as trustees in liquidation, are distributed in accord with the charitable purposes to which they should

have been devoted. This power to liquidate the assets and business of a nonstock corporation may be exercised over the property within the court's jurisdiction "of a foreign corporation that has ceased to exist." Code § 13.1-909(B). *See* former Code § 13.1-257(e) (1973 Repl. Vol.). The corporate facilities were located solely within this State in Alexandria.

Thus, we hold the trial court did not err in taking charge of the liquidation of the assets of this dissolved foreign corporation, and in providing the relief outlined in the order from which this appeal was taken. This record clearly demonstrates that the directors of JMHI, now trustees in dissolution, have failed and refused to execute the trust.

Finally, we have considered, and reject, defendants' other arguments. Only one of those contentions merits discussion. Defendants argue the trial court erred in not sustaining its plea based on the doctrine of laches.

Laches may not be pled successfully as a defense in an equitable proceeding to bar the State from asserting a claim on behalf of the public. *Board of Supervisors of Tazewell County* v. *Norfolk and W. Ry. Co.*, 119 Va. 763, 790, 91 S.E. 124, 133 (1916). *Accord City of Manassas* v. *Board of Supervisors of Prince William County*, 250 Va. 126, 132, 458 S.E.2d 568, 571 (1995). *See Dick Kelly Enter.* v. *City of Norfolk*, 243 Va. 373, 381, 416 S.E.2d 680, 685 (1992). As we already have said, this cause is brought by the Commonwealth on behalf of the public to hold and administer charitable assets. Hence, laches does not apply.

Consequently, we will affirm the judgment appealed from, an interlocutory decree adjudicating the principles of the cause, and we will remand the cause to the trial court for further proceedings.

Affirmed and remanded.

APPENDIX B

CIRCUIT COURT OF ALEXANDRIA VIRGINIA

February 7, 1997

Re: Commonwealth of Virginia, *ex rel.* v. Tauber, *et al.*
Chancery No. CH961241

Dear Counsel,

This matter is before the Court for a decision on the merits after trial. Upon consideration of the testimony, the exhibits filed, and the argument of counsel, the Court concludes that Complainant is entitled to the relief sought in the Bill of Complaint. The Court will enter a declaratory judgment that the assets of Jefferson Memorial Hospital, Inc. (JMHI) remain in the hands of Respondents as trustees; a custodian will be appointed to administer the assets; an accounting will be ordered; and a constructive trust imposed on all assets of JMHI. The relief sought by way of money damages will be denied.

The issues presented are dealt with as follows under the laws of Virginia:

I. STANDING OF COMPLAINANT TO BRING ACTION.

The Court has previously ruled in the pretrial proceedings that the Attorney General has standing and authority to bring this action both at common law and

pursuant to Title 13.1, Code of Virginia, § 909(B). The Commonwealth's Attorney for the City of Alexandria is a proper party to the claims based upon Title 55, Code of Virginia, § 29.

In view of the express provisions of § 13.1-909(B), the fact that JMHI was incorporated in Maryland does not bar the Attorney General from bringing this action in Virginia. Respondents' reliance on the prohibition against the Commonwealth from regulating the "organization and internal affairs of a foreign corporation" found in § 13.1-923(C) is misplaced as this action does not seek to regulate any organization nor any internal affairs of JMHI.

Therefore, the Court concludes that this action is properly brought.

II. BURDEN OF PROOF.

In view of the Court's finding that the transactions shown were void (as set forth later herein), the Court has allocated the burden of proof as follows:

A. The burden rests upon Complainant to prove that the transactions are void as a breach of trust by Respondents by a preponderance of the evidence. *Baylor v. Beverly Book Co.*, 216 Va. 22 (1975); *Giannotti v. Hamway*, 239 Va. 14 (1990). Since there is an indication by way of *dicta* in *Willson v. Kable*, 177 Va. 668 (1941) that the proof must be "clear, strong, and cogent", the Court also finds that Complainant has carried such a burden.

B. Respondents have argued that the nature of transactions places this case in the line of authority that makes the transactions voidable not void. Hence, they argue they are entitled to show the fairness of the transactions. *See, Owens v. Owens*, 196 Va. 966 (1955). While the Court does not agree that the transactions are merely

voidable, in such circumstances Complainant would be required to make a *prima facie* showing of misdealings and the burdens of going forward and ultimate persuasion would rest upon Respondents to show the fairness by convincing evidence. *Owens, supra,* at 972.

III. FACTS.

There is no real conflict in the evidence as to the facts surrounding the transactions and they are amply supported by the documents admitted into evidence.

After the acquisition of real estate by deed and lease by the King Street Joint Venture (KSJV) during 1962, 1963, and 1964, held by Respondent Tauber as trustee for the joint venture, a for-profit corporation was formed to transact the business of operating a hospital. The for-profit corporation was chartered in Maryland in 1963 and authorized to do business in Virginia in the same year.

In 1964, the corporate charter was amended to a "Section 501(c)(3) charitable, non-profit corporation" and JMHI did business as such until 1971. The Internal Revenue Service began investigating the possible revocation of the tax-exempt status of JMHI in 1969, culminating in the revocation in 1971. The Board of JMHI had retained counsel but withdrew its protests to IRS and accepted the revocation. Counsel was retained, according to the uncontradicted evidence, to make recommendations regarding the conversion of the corporation to for-profit status with an eye to a public sale of stock.

A Delaware for-profit corporation, Jefferson Memorial Hospital Corporation (JMHC) was formed in 1971 and a putative merger was arranged. The merger, referred to as a "F" merger, was reported on tax returns filed in 1972. The record is devoid of documents to support the merger but Respondents contend that the merger had occurred "in the minds of the directors." No evidence has

been presented to show that at that time due diligence was used to protect the interests of the beneficiaries of the charitable hospital.

Efforts were made later in 1971 and again in 1973 to effectuate the merger. Documents indicate that JMHC assumed all of the liabilities of the charity in return for its assumption of JMHI assets. The charity was to receive 5,000 shares of stock in JMHC. No transfer of the stock has been made.

There are numerous transactions shown, some of-record and some not, dealing with the real estate, the equipment, the leases, and the use of tax benefits. The transactions show an entire course of self-dealing by the directors of the charity. They were able to acquire interests in the real estate, the equipment and lease, and were able to use tax benefits belonging to the former charity to enhance the gain of the for-profit corporation. The record is replete with discussions among Respondents as to their personal profits and gains with no reference to the best interests of the beneficiaries nor of the charitable corporation. The result was the total obliteration of the non-profit corporation.

As one example, the subdivision of the real estate in 1970 in which JMHI had a 65% undivided interest resulted in the loss of this interest. In its place, JMHI obtained a 20% interest consisting of an allocated parcel. No explanation is offered. In 1973, the non-profit corporation was dissolved by the State of Maryland for failure to file necessary property taxes and filing fees. In spite of this, Respondents caused to be filed a certificate with the Commonwealth that the corporation remained in good standing.

The record reveals that the interests of the charitable corporation (and hence, the beneficiaries of the charity) were given no consideration by the directors who were operating out of motives of self-gain and inurement.

The transactions are convoluted and complex with off-record real estate transactions conflicting with the state of the title as shown on-record. Net operating losses were used as tax deductions by JMHC that had become deductions are a result of the revocation of JMHI's tax exempt status. When Respondents had exhausted these deductions, they began seeking ways to benefit their own tax status through a complicated series of notes and bonds, and while some personal risk was taken, the Respondents and others were participating in the venture in basically a risk-free manner.

Respondents claim that JMHI had no value at the time it was changed to a for-profit corporation and, therefore, the transactions by which they assume control of the corporate assets by the assumption of its liabilities were fair.

The evidence as to the valuation of this entity is conflicting. The experts have disagreed not only in their conclusions but with the methodology employed. The Court finds that in 1971, the time of the change to for-profit, the corporation (JMHI) had value. It had value as a "going concern" with growing revenues but an erratic pattern of net earnings. However, Respondents' experts are the more persuasive and the Court finds that Respondents have carried their burden of showing that the value of the corporation did not exceed its liabilities.

However, this does not constitute a defense to the claims made here for reasons that follow.

IV. TRUSTS.

As used in this opinion, the term "void" is construed to mean voidable at the election of the *cestui que* trust.

The directors of a not-for-profit corporation hold the assets in trust for the beneficiaries and their duties are identical to those imposed on trustees of a trust. *Adelman v. Conotti Corp.*, 215 Va. 782, 789 (1975).

In *Rowland v. Kable*, 174 Va. 343 (1940), the Court drew a distinction between those cases where the directors profit from the property of their corporation, in which event the transaction is void, and those cases where the director deals with the corporation with its consent, in which event the transaction is merely voidable if unfair. The Court, quoting *Deford v. Ballentine Realty Corporation*, 164 Va. 436, 440 (1935), said in stating the majority rule:

> There is a distinction to be made between transactions occurring directly between a trustee and his *cestui que* trust and those transactions in which the trustee deals with himself in respect to the trust estate. The latter class of transactions are voidable by the *cestui que* trust at his election without giving any reason or alleging any fraud, or any advantage or inadequacy of price. *Rowland, supra*, at 368-69.

The actions of these directors are voidable at the option of the beneficiaries of the trust imposed upon them without proof of an actual injury. *See, Rowland, supra*, at 366; *See also, Kessler v. Commonwealth Doctors Hospital*, 212 Va. 497 (1971). In the case of a charitable non-profit corporation, the public as represented by Complainant are the beneficiaries of the trust.

At common law, then, Respondents hold the assets of JMHI in trust for the public.

In addition, it is clear under Virginia law (Maryland law being similar) that directors of a dissolved corporation become formal trustees upon dissolution and hold for the benefit of the creditors and shareholders if for-profit or for the public if non-profit. Since the Court finds that no merger of JMHI and JMHC has occurred and that the transactions by directors of JMHI are void, the assets remained in JMHI until its dissolution. At the time of dissolution, these assets passed into and remain in the hands of Respondents as trustees.

Under Title 13.1 Code of Virginia, § 909(B), this Court has the authority to liquidate the assets and business of JMHI at any time after termination of its existence and whether the corporation was domestic or foreign. The corporation (JMHI) has property and interests located here and no where else. Section 13.1-910 provides the method for liquidation by appointing receivers to manage, wind up and liquidate the corporation.

Pursuant to Title 55, Code of Virginia, § 29, where trustees of any trust such as that imposed on directors of a non-profit corporation refuse to act then the Court may, in an action against the trustees, appoint trustees to execute the trust. Here there is little doubt that the trustees, the directors of JMHI, have refused to execute the trust; thus, this Court may appoint substitute trustees.

V. LACHES AND GOOD FAITH.

Respondents claim that an undue delay, some twenty-four (24) years from the date of the initial transaction complained of, coupled with the death and disability of witnesses and parties, has resulted in prejudice to their ability to present a defense. Complainant argues that laches, as raised by Respondents, does not apply to the Commonwealth and that the real party in interest is the Commonwealth.

The Court ruled at pretrial that Respondents would not be barred from presenting evidence on this issue; relying on authorities that seemed to hold that laches may apply in cases of a charitable corporation but that equity was reluctant to apply the doctrine in such cases. *See*, Bogert, *The Law of Trusts & Trustees*, § 411, 948 and 949 (1984).

It has been said that Courts of equity are less inclined to apply the doctrine to a charitable trust or against a government. *Mount Vernon Mortgage Corp. v. United*

States, 236 F.2d 724, (D.C. Cir. 1956), *Cert. Denied*, 77 S. Ct. 386 (1957).

In Virginia, neither the statute of limitations nor laches may be asserted as a defense in an equitable proceeding to bar the state from asserting a claim on behalf of the public. *Supervisors v. N.&W.R. Co.*, 118 Va. 763, 790 (1916), as cited in *City of Manassas v. Board of Supervisors*, 250 Va. 126 (1995). The Court concludes that this cause is brought by the Commonwealth "on behalf of the public" and not to protect private interests as argued by Respondents. Hence, laches does not apply.

Even if the doctrine could be asserted, Respondents have not carried their burden of showing that the doctrine should bar this action. While the passage of time is significant, no evidence of substantial prejudice has been shown. The transactions questioned by Complainant are clearly documented and are basically not in dispute.

No showing has been made as to what evidence Respondents have been prevented from presenting as a result of the deaths and disabilities alleged. There is one example in which JMHC was identified by an accountant who has since died as JMHI well after the purported merger. Respondents argue that this would have been shown to be a mistake by the accountant. The circumstances surrounding the document are evidence from which the Court could conclude such an error and no prejudice results to Respondents.

In addition, there is no persuasive evidence that the Commonwealth had such notice of the change in the corporate structure as to trigger its right to act. The documents reveal at best confusion and at worst an intent to mislead the authorities as to the structure of the hospital. The continued use of JMHI's tax identification number, the off-record transactions, the use of JMHI's operating license to operate the hospital, the attempts to "clean up" the transaction in later years, and failure to record and

file proper documents all serve to indicate a lack of notice to Complainant. With the heavier burden resting on Tauber's shoulders because of the nature of the claim, it is clear that there has been no showing of laches in this case.

Respondents argue that they were operating in good faith and argue that many of the transactions were done with advice of counsel. In view of the Court's finding that the nature of the transactions render them void not voidable, the good faith of Respondents, even if shown, would not be a defense and the transactions are voided at the election of the *cestui que* trust. *Kessler, supra,* at 503.

In any event, the record reflects a failure on Respondenst part to give full and complete information to counsel when advice was sought and, therefore, the advice could not be asserted as a defense. If this defense was available, it would require a showing of acting in good faith on advice of reputable counsel after full disclosure of the facts. *Edwards v. Carey*, 219 Va. 90 (1978) (a case dealing with an action for malicious prosecution).

VII. RES JUDICATA.

Respondents in 1994 filed a bill in this Court to quiet title to the real property at issue in this case. Service was had by publication against unknown parties claiming an interest. The Commonwealth was not identified as a party nor served with process.

Respondents now claim that Complainant is barred by its failure to intervene and respond in that suit to protect its interests. *Res judicata* would not apply under these circumstances. *O'Hara v. Pittston Co.*, 186 Va. 325, at 344-346 (1947).

Respondents failed to join the Commonwealth when they knew of the existence of the potential claim and they now assert that the Commonwealth was a necessary party

to the quiet title action so that it is bound by the judgment. Having failed to join a known party whom they claim to be necessary to an adjudication of the issues, the Respondents cannot now be heard to complain of the failure of the Commonwealth to respond.

VIII. REMEDIES.

Having granted the relief sought the Court must fashion the remedy. Counsel should schedule a prompt hearing to discuss the possible methods for carrying out the Court's ruling including appointment of a Commissioner in Chancery, substitute trustees, or custodians.

Counsel may also wish to consider whether judicial economy is best served by an appeal pursuant to Title 8.01, Code of Virginia, § 670(B)(3), if they are so advised.

Complaint shall prepare for presentation a decree embodying the ruling of the Court.

Very truly yours,

/s/ Alfred D. Swersky
ALFRED D. SWERSKY

VIRGINIA:

IN THE CIRCUIT COURT
FOR THE CITY OF ALEXANDRIA

CHANCERY NO. CH961241

COMMONWEALTH OF VIRGINIA, *et al.*,
Complainants

v.

LASZLO N. TAUBER, *et al.*,
Respondents

ORDER

This cause came to be heard upon the merits at a trial commencing on January 21, 1997, until its conclusion; upon the testimony, exhibits and argument of counsel. It appearing to the Court for the reasons stated and fully set forth in its opinion letter dated February 7, 1997, which letter is incorporated herein, it is

ORDERED, ADJUDGED and DECREED that a declaratory judgment be, and it hereby is, entered that the assets and liabilities of Jefferson Memorial Hospital, Inc., be, reside and remain with Respondents as trustees and further that a constructive trust be and it hereby is imposed on such assets and liabilities; further, it is

ORDERED, ADJUDGED and DECREED that a custodian, the identity to be determined by this Court, be appointed with exclusive jurisdiction to hold and administer the said assets and liabilities in whatever form and whereever located; further, it is

ORDERED, ADJUDGED and DECREED that the Respondents shall prepare and submit under oath a full and complete accounting of all assets and liabiliities that are the subject of this Decree within sixty (60) days hereof and Complainant shall respond within thirty (30) days of the receipt, which accountings shall disclose all rents, issues, profits, accretions, and benefits, tangible and intangible, which have accrued therefrom and further proceedings shall be had and further evidence taken, if necessary, by this Court; further, it is

ORDERED, ADJUDGED and DECREED that Respondents shall not convey any property, real, personal, tangible, or intangible, without approval by decree of this Court and Complainant shall cause a copy of this Decree to be spread among the land records of the City of Alexandria or any other jurisdiction wherein such property may be located; further it is

ORDERED, ADJUDGED and DECREED that the custodian appointed by this Court shall submit for approval by this Court a plan for the use of disposition of the assets and liabilities of Jefferson Memorial Hospital, Inc., and further, it is

ORDERED, ADJUDGED and DECREED that Complainants' claim for monetary damages be and it hereby is denied.

Entered this 3rd day of March, 1997.

/s/ Alfred D. Swersky
ALFRED D. SWERSKY
Judge

The objections of all parties as noted in the record are hereby preserved.

Copies to all Counsel of Record

APPENDIX C

IN THE
SUPREME COURT OF VIRGINIA
CITY OF RICHMOND

Record No. 971155

Circuit Court No. CH961241

LASZLO N. TAUBER, *et al.*,
Appellants,

against

COMMONWEALTH OF VIRGINIA, ETC., *et al.*,
Appellees.

PETITION FOR REHEARING

June 5, 1988

On consideration of the petition of the appellants and the letter in support thereof to set aside the judgment rendered herein on the 17th day of April, 1998 and grant a rehearing thereof, the prayer of the said petition is denied.

A Copy,
Teste:

/s/ David B. Beach
Clerk

APPENDIX D

CONSTITUTIONAL PROVISIONS

Article I, § 8, Clause 3

> The Congress shall have Power To . . . regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

Article IV, § 1

> Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.

Amendment XIV, § 1

> All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.